Mid-year manager roundtable: equity market reflections

With the imminent publication of UOBAM's 3Q22 Quarterly Investment Strategy report, we bring together three portfolio managers who are actively involved in the development of the firm's equity strategy. We ask them for their key takeaways from the extreme equity market volatility seen in the first half of the year.

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Anthony Raza, Senior Director, Multi-Asset Strategy, UOBAM

Tony joined UOBAM in 2008 and leads the multi-strategy team in its monitoring of global markets, formulation of house views and development of investment recommendations. He also manages a range of asset allocation products. Tony has over 30 years of investment experience.

Paul Ho Senior Director, Asia Pacific Equities

Paul has over 27 years of investment experience and manages a number of Asian funds at UOBAM. He currently leads UOBAM's initiatives to apply Artificial Intelligence (AI) within various investment solutions. Paul graduated with First Class Honours from Oxford University, United Kingdom.

Choo Chian Director, Multi-Asset Strategy, UOBAM

Choo Chian is responsible for managing several Global and Asian multi-asset portfolios. Prior to joining UOBAM, Chian was a Lead Portfolio Manager for Global Markets at Monetary Authority of Singapore (MAS), Chian has over 18 years of investment experience.

US and global equity markets have declined by close to 20 percent since the start of the year, wiping out most of the gains made since the end of the Covid crisis. What are the lessons for equity managers?

Tony: The first half of 2022 was a reminder of how troubling inflation can be for financial markets. Prior to this, we had a decade of disinflation and four decades of declining inflations trends. These allowed for monetary and fiscal policies that were strongly supportive of markets. 1H22 demonstrated that, even when global growth is strong and the world is reopening after a pandemic, inflation fears can cause both stocks and bonds to perform terribly, leaving investors with nowhere to hide. Now economists are dusting off their inflation textbooks and trying to understand why disinflation lasted so long previously, and how inflation can rebound so suddenly. Confusing as it is, economists and markets are learning a lot about what it takes to turn off the global economy, and hopefully turn it on again, including how various policies have helped or hurt.

Paul: I agree with Tony. What made 1H22 such a very difficult period for equity managers was not just the market volatility but also the “unexpected” rate of increase in inflation and interest rates. I think many people are still influenced by what psychologists call the recency bias. We had been through many years of bull market without much volatility, low inflation and low interest rates. Then, when the markets started changing, many investors were unable to change their mindset or adjust to the new reality in a timely manner. So for me, the greatest lesson from 1H22 is to always focus on the data and be ready to change your mind when the market changes.

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Anthony Raza

Chian: I think one of the big market lessons of 1H22 is that equities, despite being regarded as “growth assets” and therefore expected to perform well when growth is positive, can also be highly sensitive to interest rate macro trends. Investors reacted to the prospect of sharp interest rate rises by discounting the future earnings of growth and tech stocks. They also felt that that the revenue streams for this sector - being more global in nature - would be more impacted by the cyclical slowdown in the Eurozone and Asia. While such global macro trends have worked in our favour, it is worthwhile to bear in mind that reading the tea leaves on inflation and interest rates can be as important for an equity investor as a bond investor.

Despite six months of volatility, equity markets are showing no signs of stabilising. In fact, June was the most volatile month so far this year. Are there more surprises that could unnerve investors going into 2H22?

Paul: I think one potential big surprise is a deeper-than-expected recession in the US. We are starting to see data to support this possibility. Consumer sentiment is plunging while consumer revolving credit is growing rapidly. Meanwhile record high inventories are building up in the retail and semi-conductor sectors. I am also concerned by news of layoffs by companies from Tesla to Walmart. This is likely because higher than expected energy costs and a stronger USD is putting pressure on corporate profits.

“One big potential surprise is that corporates’ net profit margins start to shrink significantly due to rising cost pressures”

Choo Chian

Tony: If there is one number that economists are wishing they could forecast perfectly, it would be inflation. I feel that this number would tell us where markets are going in 2H22. If it surprises positively, both stock and bond markets will recover well and the reverse is true if it surprises negatively. However, I think expectations are already quite bad for inflation, whereas a positive surprise is not adequately priced in. Cars, airlines, oil, and shelter are the biggest inflation drivers and there are early signs that inventories are growing again, the housing market is cooling off and oil and airline prices are settling down. if this lowers inflation but avoids a recession, there is room for a lot of relief in equity markets.

Chian: Global equity markets seem relatively sanguine that low double-digit earnings growth is achievable this year and next. One big potential surprise is that corporates' net profit margins start to shrink significantly due to rising cost pressures. If so, earnings could fall short of market expectations. In light of continued supply-side disruptions, corporates are also keen to have more secure supply chains, which would invariably entail higher operating costs. This cost-push inflation could take a material bite out of earnings, a phenomenon that market participants may not be prepared for.

Many retail investors are looking to reduce their equity exposures, having been badly hit by negative returns. Others believe that market corrections cannot last much longer and are starting to bottom fish. What is your advice for equity investors as we head into 2H22?

Chian: Many investors are currently hoping that growth equities will revive and stage a strong comeback in 2H22. I would advise against betting on such hopes. At this stage, we cannot rule out more interest rate uncertainty and inflation is unlikely to ease enough in the short term to give comfort to central bankers. As such, I would suggest investing in relatively more stable value and cyclical stocks, plus inflation-sensitive plays such as natural resource and infrastructure. High dividend-yielding stocks also tend to outperform in moderate economic expansion and high inflation environments. Equity investors can also consider a portfolio approach by including a broader array of financial assets. This can help maximise market opportunities while minimising market drawdowns.

"Investors must have the discipline and patience to stick to the investment plan, especially in testing times like these"

Paul Ho

Paul: Investors have to accept that the market moves in cycles over time and that it can be hard to time the top and bottoms. And as we have seen in 1H22, the market always surprises investors. In the face of such uncertainty, it is important to own a well-constructed and diversified portfolio made up of different asset classes that can do well in different economic conditions. Portfolios also need to be rebalanced periodically, especially if you are holding for the long term. And of course, investors must have the discipline and patience to stick to the investment plan, especially in testing times like these.

Tony: I would advise investors to brace for continued market volatility in the near-term. We expect equities to continue to be weighed down by signs of slowing growth. Even if growth doesn't slow to recessionary levels, it is hard for equities to rally under such circumstances. However, we are aware that opportunities are growing for long term investors. Valuations have improved a lot and multi-year business prospects remain healthy. We would also remind investors that a large part of the inflation problem is because supply cannot keep up with demand. This means global demand is not weak, and corporations are finding ways to produce more and more efficiently. Even if the Fed eventually manages to cool off growth, corporates will have a strong foundation from which to recover.

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